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BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of)	<u>D E T E R M I N A T I O N</u>
Assessment of)	
)	No. 11-0001
)	
...)	
)	Registration No. . . .
)	Document No. . . ./Audit No. . . .
)	Docket No. . . .
)	

[1] RULE 15501; RCW 82.08.020; RCW 82.04.290: DEFFERED SALES TAX – TAXABILITY OF ONLINE PROPERTY MANAGEMENT SERVICES – PRE-DIGITAL PRODUCTS LEGISLATION. Prior to the advent of digital products legislation, Taxpayer’s purchase of online property management services, which consists of a combination of software as a service (SAAS), information services, and data processing, is taxable under the service and other activities business and occupation tax category, and therefore taxpayer is not liable for deferred sales taxes on such services.

[2] RCW 82.04.050; RCW 82.04.192; RCW 82.12.020: DEFERRED SALES TAX AND/OR USE TAX – TAXABILITY OF ONLINE PROPERTY MANAGEMENT SERVICES – POST-DIGITAL PRODUCTS LEGISLATION. Following the enactment of digital products legislation, Taxpayer purchase of the same online property management services equates to the purchase of digital automated services (DAS) for which Taxpayer owes deferred sales tax and/or use tax.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

Pardee, A.L.J. – A property management company objects to the Department’s assessment of use tax and/or deferred sales tax on its purchase of online property management services from a third party, and argues that it merely purchased a service not subject to retail sales tax. We grant Taxpayer’s petition for periods prior to the advent of digital products legislation, and uphold the Department’s assessment for periods after the effective date of the digital products legislation.¹

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

ISSUES

1. Prior to the effective date of digital products legislation (July 26, 2009), does Taxpayer owe deferred sales tax on its purchase(s) of online property management services under RCW 82.08.020 and WAC 458-20-15501?
2. Following the enactment of digital products legislation (on July 26, 2009), does Taxpayer owe deferred sales tax on its purchase(s) of online property management services under RCW 82.04.050 and RCW 82.04.192?

FINDINGS OF FACT

[Taxpayer], located in . . . Washington, provides property management services for single-family residences. A Subscription Agreement (Invoice) dated November 11, 2008, between [an out-of-state online property management services company] and Taxpayer, indicates that Taxpayer paid [the online property management services company] \$. . . to use its . . . service. The Invoice is broken down into two amounts; a one year subscription to [its] service (including maintenance) totaling \$. . ., and . . . a one-time data import implementation fee of \$. . . . The Invoice reads: “Use of licenses purchased under this contract shall be governed in all cases by the [Invoice] and [the online property management services company’s] Terms of Use. . . .” Paragraph 3 of [the online property management services company’s] Terms of Use reads:

[The online property management services company] hereby grants User a revocable, non-exclusive, non-transferable, worldwide right to use *the Service*, solely for User’s own internal business purposes, subject to these terms of Use (*the “License”*). . . .

User licenses may be used by any number of employees, representatives, consultants, contractors or agents within a single User organization, but cannot otherwise be shared or used by more than one User entity.

(Emphasis added). The [the online property management services company’s] service that [its] customers (including Taxpayer) receive contains the following features:

- Customers do not manage servers, and receive no software from [the online property management services company] to install or upgrade. Customers simply access [the online property management services company’s] website . . . by signing in to their account. [C]ustomers then have access to every function of the web-based program. . . .
- Once [the online property management services company] has imported the customer’s information (i.e., data), it sets up the customer’s bank accounts, accounting preferences, management fee rules, etc. [The online property management services company’s] service allows its customers to access current information on key indicators for their business
- Customers can syndicate listings across the web, process electronic payments, manage work orders, screen applicants, and service their clients using online portals. . . .

The Department’s Audit Division (Audit) examined Taxpayer’s books and records for the period January 1, 2006, through December 31, 2009. On March 24, 2010, the Department issued

Taxpayer an assessment . . . totaling \$. . ., including \$. . . of use tax and/or deferred sales tax, and \$. . . of interest. Schedule 3 of the Assessment assessed Taxpayer use tax and/or deferred sales tax on consumable supply purchases from two companies:

- (1) Taxpayer's purchase of the [the online property management services company's] service (three invoices);² and
- (2) Taxpayer's purchase of training from³

With regards to (1) above, Audit contends that the Taxpayer bought a license to use software when it purchased the [online property management services company's] service, which is subject to retail sales tax. Taxpayer disagrees with Audit's conclusion, and contends that what it purchased from [the online property management services company] was a non-taxable service.

ANALYSIS

The retail sales tax is levied on each retail sale in this state, measured by the selling price. RCW 82.08.020; WAC 458-20-107(1). RCW 82.08.050(1) states that the retail sales tax "shall be paid by the buyer to the seller, and each seller shall collect from the buyer the full amount of the tax payable in respect to each taxable sale" RCW 82.08.050(10) states that "Where a buyer has failed to pay to the seller the tax imposed by this chapter and the seller has not paid the amount of the tax to the department, the department may, in its discretion, proceed directly against the buyer for collection of the tax"

1. Taxation of [online property management services company] Service Under WAC 458-20-15501 (Pre-Digital Products Legislation)

[1] Gross income received for providing remote access to applications on the host's servers (i.e., software as a service - SAAS) is subject to Service and Other Activities business and occupation (B&O) tax, when the service is performed in Washington. WAC 458-20-15501(401)(g) (Rule 15501(401)(g)). SAAS, sometimes referred to as "software on demand," is software that is deployed over the internet and/or is deployed to run behind a firewall on a local area network or personal computer.⁴ With SAAS, a provider licenses an application to customers either as a service on demand, through a subscription, in a "pay-as-you-go" model, or (increasingly) at no charge.⁵ This approach to application delivery is part of the utility computing model, where all of the technology is in the "cloud," accessed over the internet as a service.⁶

² Audit's response to Taxpayer's appeal indicates that the two additional invoices [the online property management services company] issued Taxpayer totaled \$. . ., and were issued November 20, 2009, and December 14, 2009. Audit claims it never reviewed these invoices.

³ On August 10, 2010, Taxpayer provided paperwork that shows that number (2) is non-taxable training, and Audit has agreed to this, and will make the appropriate adjustment to the Assessment.

⁴ http://en.wikipedia.org/wiki/Software_as_a_service.

⁵ *Id.*

⁶ *Id.* SAAS has the following advantages:

- Accessible from anywhere with an internet connection
- No local server installation or hardware required

Rule 15501(401)(g) provides the following example of SAAS:

- (i) BE Software, Inc., offers a variety of prewritten software products on-line, but not for download, to its customers for a monthly subscription fee. BE Software is subject to service and other activities B&O tax for its subscription fees received.

Taxpayer accesses [the online property management services company's] software products online, does not have the ability to download such products, and pays [the online property management services company] an annual subscription fee. Taxpayer, and other [customers of the online property management services company], *receive a license to use the* [the online property management services company's] *service*, which allows their employees to access the service online. [The online property management services company's] service consists of predominately SAAS that is subject to Service and Other Activities B&O tax. The [the online property management services company's] service also contains other features, however, which are classified differently for tax purposes, but have the same tax consequences.

Gross income received for information services is also subject to Service and Other Activities B&O tax. Rule 15501(401)(a). "Information services" means every business activity, process, or function by which a person transfers, transmits, or conveys data, facts, knowledge, procedures, and the like to any user of such information through any tangible or intangible medium. Rule 15501(401)(a)(i). "Information services" does not include transfers of tangible personal property such as computer hardware or standard prewritten software programs. *Id.* The following example of information services is provided:

- (B) ZZ Statistical Data, Inc., allows its customers to perform on-line research of statistical information through its data base. ZZ bills its customers a monthly fee for having on-line access to the data base for research. Its customers do not download any information onto their computers. ZZ is subject to service and other activities B&O tax for providing information services to its customers.

Rule 15501(401)(a)(ii).

[The online property management services company's] service allows its customers (including Taxpayer) to perform on-line research of key business indicators, track work orders, screen applicants, and process payments. [The online property management services company's]

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- Pay per use or subscription based payment methods
 - Instant scalability – A desirable property of a system, a network, or a process, which indicates its ability to either handle growing amounts of work in a graceful manner, or its ability to be enlarged.
 - System Maintenance (backup, updates, security, etc) often included in service
 - Security
 - Reliability
 - API (Application Programming Interface) – That serves as an interface between different software programs and facilitates their interaction, similar to the way the user interface facilitates interaction

customers access such information online, and do not download any information onto their computers. In this regard, Taxpayer provides its customers with information services, which is subject to Service and Other Activities B&O tax as well. Finally, the [the online property management services company's] service also contains an element of data processing, which is taxed similarly.

Gross income received for data processing services is subject to Service and Other Activities B&O tax. Rule 15501(401)(b). "Data processing services" includes, but is not limited to, word processing, data entry, data retrieval, data search, information compilation, payroll processing business accounts processing, data production, and other computerized data and information storage or manipulation. *Id.* "Data processing services" also includes the use of a computer or computer time for data processing whether the processing is performed by the provider of the computer or by the purchaser of other beneficiary of the service. *Id.* The following example of data processing services is provided in the rule:

- (i) Example. JK Processing, Inc., provides payroll processing services to other businesses. JK is subject to service and other activities B&O tax for providing data processing services.

Rule 15501(401)(b).

As the Invoice notes, [the online property management services company] charges its customers a one-time data implementation fee. As [the online property management services company's] website attests to, a segment of the [the online property management services company's] service is dedicated to importing the customer's data, and configuring it. [The online property management services company's] service includes a data processing element, which is subject to Service and Other Activities B&O tax.

Therefore, prior to July 26, 2009, [the online property management services company's] service is subject to Service and Other Activities B&O tax, [and] Taxpayer does not owe deferred sales tax on the Invoice totaling \$. . .

2. Taxation of [the online property management services company's] Service (Post-Digital Products Legislation)

Digital products legislation, effective July 26, 2009, introduces the concept of digital automated services (DAS), and addresses how such services are taxed.

The term "sale at retail" or "retail sale" includes the following sales to consumers of digital automated services:

- (ii) Sales in which the seller has granted the purchaser a right of use that is less than permanent . . .

(iv) Sales in which the purchaser is obligated to make continued payment as a condition of the sales.

RCW 82.04.050(8)(a). A retail sale of DAS under RCW 82.04.050(8)(a) includes any services provided by the seller exclusively in connection with digital automated services, whether or not a separate charge is made for such services. RCW 82.04.050(8)(b).

Use tax is owed for the privilege of using within this state as a consumer any DAS, including the use of any services provided by a seller exclusively in connection with DAS, whether or not a separate charge is made for such services. RCW 82.12.020(1)(e)(i). With respect to the use of DAS purchased, use tax applies in respect to sales in which the seller has granted the purchaser a right of use that is less than permanent, or sales in which the purchaser is obligated to make continued payment as a condition of the sale. RCW 82.12.020(1)(e)(ii)(B) and (D).

“Digital automated service” (DAS) means any service transferred electronically that uses one or more software applications. RCW 82.04.192(3)(a). However, DAS does not include the following:

(xv) Data processing services. For purposes of this subsection (3)(b)(xv), “data processing service” means a primarily automated service provided to a business or other organization where the primary object of the service is the systematic performance of operations by the service provider on data supplied in whole or in part by the customer to extract the required information in an appropriate form or to convert the data to usable information. Data processing services include check processing, image processing, form processing, image processing, form processing, payroll processing, claim processing, and similar activities. Data processing does not include the service described in RCW 82.04.050(6)(b).

RCW 82.04.192(3)(b).

The primary object of the [the online property management services company’s] service is for [the online property management services company] to provide its customers with DAS (formerly SAAS and information services), even though [the online property management services company] initially imports a customer’s data, and may convert existing data into reports with business indicators or other information. The primary object of the [the online property management services company’s] service is not for [the online property management services company] to perform services similar to check processing, image processing, payroll processing, etc.⁷

⁷ In *Silverstreak, Inc. v. Washington State Dep’t of Labor and Industries*, 159 Wn.2d 868, 882, 154 P.3d 891 (2007), the Washington Supreme Court articulated the rule of ejusdem generis canon of statutory construction as follows:

The rule of ejusdem generis requires that general terms appearing in a statute in connection with specific terms are to be given meaning and effect only to the extent that the general terms suggest similar items to those designated by the specific terms. *Davis v. Dep’t of Licensing*, 137 Wash.2d 957, 970, 977 P.2d 554 (1999); *Dean v. McFarland*, 81 Wash.2d 215, 221, 500 P.2d 1244 (1972). “ [S]pecific terms modify or restrict the application of general terms, where both are used in sequence.” *Davis*, 137 Wash.2d at 970,

The service which [the online property management services company] provides Taxpayer and other customers, is classified as a digital automated service, which is subject to retail sales tax. This new classification effectively supercedes the tax treatment of SAAS and information services under Rule 15501.⁸ Amounts [the online property management services company] invoices its customers (including Taxpayer) for its DAS on or after July 26, 2009, are subject to retail sales tax. If Taxpayer does not pay retail sales tax upon the purchase of these services, it is subject to use tax upon the use of the DAS in Washington. Therefore, we uphold the Department's assessment of deferred retail sales and/or use tax against Taxpayer on [the online property management services company] invoices issued after July 26, 2009.

DECISION AND DISPOSITION

For periods prior to July 26, 2009, the Department grants Taxpayer's objection to the assessment of deferred sales taxes on its purchase of services from [the online property management services company], and on the purchase of . . . training. The Department denies Taxpayer's petition in all other respects.

Dated this 4th day of January 2011.

977 P.2d 554 (quoting *McFarland*, 81 Wash.2d at 221, 500 P.2d 1244); see also *In re Estate of Jones*, 152 Wash.2d 1, 11, 93 P.3d 147 (2004).

⁸ [However, while not at issue here, some SAAS qualifies as remote access software, and not DAS. The digital products legislation (ESHB 2075), in addition to introducing the concept of DAS, also added additional language to RCW 82.04.050(6) which defines the sale of remote access software as a retail sale, which prior to July 26, 2009, had also been defined under Rule 15501(401)(g) as a non-retail sale (subject to Service and Other Activities B&O tax):

(b)(i) The term also includes the charge made to consumers for the right to access and use prewritten computer software, where possession of the software is maintained by the seller or a third party, regardless of whether the charge for the service is on a per use, per user, per license, subscription, or some other basis.

(ii)(A) The service described in (b)(i) of this subsection (6) includes the right to access and use prewritten computer software to perform data processing.]